VZCZCXYZ0014
PP RUEHWEB

DE RUEHCV #1365/01 2731430
ZNY CCCCC ZZH
P 291430Z SEP 08
FM AMEMBASSY CARACAS
TO RUEHC/SECSTATE WASHDC PRIORITY 1878
INFO RUEHBO/AMEMBASSY BOGOTA 7866
RUEHLP/AMEMBASSY LA PAZ SEP LIMA 1091
RUEHQT/AMEMBASSY QUITO 2905
RHEHNSC/NSC WASHDC
RUMIAAA/HQ USSOUTHCOM MIAMI FL
RUCPDOC/DEPT OF COMMERCE
RUEATRS/DEPT OF TREASURY

C O N F I D E N T I A L CARACAS 001365

SIPDIS

HQ SOUTHCOM ALSO FOR POLAD
TREASURY FOR MMALLOY
NSC FOR JSHRIER
COMMERCE FOR 4431/MAC/WH/MCAMERON

E.O. 12958: DECL: 04/23/2018
TAGS: ECON EFIN VE
SUBJECT: STRUCTURED NOTE DEADLINE PASSES, ISSUE FIZZLES

REF: A. CARACAS 930
¶B. CARACAS 1338

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b) a
nd (d).

¶1. (SBU) Summary: On September 24 the deadline for Venezuelan banks to sell their holdings of bolivar-denominated structured notes passed with little apparent effect on the banking sector. The Bolivarian Republic of Venezuela (BRV) showed an unusual amount of flexibility in its implementation of the resolutions ordering banks to sell these notes, and as a result appears to have limited damage to the sector. Banks holding small amounts of these notes have probably been able to sell them off with little impact on their balance sheets, and those with larger positions can take advantage of a loophole allowing them to replace the strucutured notes with derivatives to limit their losses. The whole affair will probably have little long-term impact on the banking sector, but it provides one more example of the risks resulting from the BRV's inconsistent regulations. END SUMMARY.

The Deadline Passes

¶2. (U) The BRV's September 24 deadline for Venezuelan financial institutions to sell their holdings of bolivar-denominated structured notes passed with little fanfare and no indication of serious problems at any Venezuelan banks. (NOTE: These notes are tied to dollar assets held at foreign banks and are distinct from the dollar-denominated structured notes that Qe BRV has periodically sold to intervene in the parallel exchange market, although in some cases these notes may be backed by the dollar-denominated variety. Venezuelan banks had been using these notes to hide dollar assets on their balance sheets and circumvent BRV regulations limiting banks' net position in foreign currency to 30 percent of total capital. END NOTE) It appears that the May and June BRV resolutions ordering banks to divest their holdings of bolivar-denominataed structured notes, which generated concerns that government action could make a handful of banks insolvent (ref A), have in fact made little impact on the sector.

The BRV Shows Some Flexibility

¶3. (C) The BRV has been unusually pragmatic in its implementation of the structured notes resolutions. Our contacts believe Finance Minister Ali Rodriguez recognized the potential risks these resolutions posed to the banking sector and extended the deadline for compliance in response. (NOTE: The BRV's initial deadline was thought to be August ¶19. However, Ali Rodriguez in early August stated that market participants had misconstrued the wording of the resolutions and that the BRV deadline should be calculated only counting working days, effectively increasing the time banks had to sell the structured notes by six weeks. END NOTE) The BRV also appears to be tailoring its response to conditions at individual banks holding the notes. Chief Economist for the Venezuelan Banking Association Jesus Bianco (PROTECT THROUGHOUT) told Econoffs September 16 that banks with large positions in structured notes had been able to negotiate with Venezuela's bank regulator (SUDEBAN) to allow short-term structured notes to mature while providing additional time to unwind their holdings of long-term notes.

Getting the Notes off the Balance Sheet

¶4. (C) Several of our contacts have told us that many of the banks holding these structured notes have been able to sell them ahead of the government's deadline with only a marginal effect on their balance sheets. Nelson Mezerhane (PROTECT THROUGHOUT), owner of Banco Federal, told Econoffs September 23 that his bank had sold its notes and their associated dollar assets at a "small loss" and that SUDEBAN granted the bank 18 months to amortize the loss. Banco Federal as of December 2007 held structured notes worth about USD 1.5 billion at the official exchange rate. Press reports on September 24 indicated that Banco Occidental del Descuento (BOD), another bank thought to have more than USD 1 billion in structured note holdings, had been able to unwind its position with little effect on the bank's balance sheet.

¶5. (C) Banks may not necessarily need to sell the dollar assets tied to their structured notes to achieve compliance with the BRV's regulations. Jesus Bianco relayed to Econoffs that banks with larger positions are likely to roll their dollar assets into derivatives that will once again reduce the amount of foreign currency assets apparent on their balance sheets. While there is no significant financial difference between structured notes and derivatives, derivatives give banks the necessary legal cover to avoid surpassing the 30 percent limit. One contact told us BOD had rolled its structured notes into derivatives; on the other hand, Nelson Mezerhane told us Banco Federal had converted the proceeds of its structured note sales into bolivars. Bianco also believes that banks unwinding their structured notes positions will take losses of around 10 percent on average, which would likely be apparent when their audited financial statements for 2008 are released in March of 2009, but banks may be able to hide these losses by shifting dollar assets into derivatives.

In the End, Little Effect on the Sector

¶6. (C) Venezuela's banking sector appears to have successfully managed the BRV's regulations, and banks are unlikely to drastically change their practices as a result. Indeed, one of the most confusing aspects of the BRV's insistence that banks divest their bolivar-denominated structured notes was that many of these notes were smart hedges protecting banks from the possibility of a devaluation of the bolivar. While the value of local currency assets would decline if the bolivar was devalued, the dollar assets tied to these notes would retain their value and limit the negative effects on banks' balance sheets. Bianco told Econoffs that this type of hedging had long been practiced by Venezuelan banks, and that international investment position

statistics normally show the sector holding about 50 percent of its bond portfolio in foreign currency. Because Venezuela's banks retain the ability to hide their foreign currency holdings through derivatives, they will probably continue to hedge against a devaluation by buying dollar assets and will remain a willing market for the BRV's issuances of dollar-denominated debt.

¶7. (C) There does appear to have been an unintended silver lining to the BRV's resolutions, however. A significant portion of the structured notes held by Venezuelan banks were issued by the now bankrupt Lehman Brothers, and the BRV's regulation may have limited Venezuelan exposure to the firm. Asdrubal Oliveros (PROTECT), director of the economic consulting firm Ecoanalitica, told Econoffs September 22 that as much as USD 1 billion of the estimated USD 5 billion in bolivar-denominated structured notes held in Venezuelan banks

as of May were issued by Lehman Brothers. Banks sold off about USD 600 million of these notes in the wake of the BRV resolutions, limiting the sector's exposure to around USD 400 million (ref B).

Comment

¶8. (SBU) While the BRV resolutions ordering banks to sell their bolivar-denominated structured notes generated headlines and concern across Venezuelan banks, SUDEBAN and the Ministry of Finance have so far managed to avoid bank failures. By keeping open a loophole allowing banks to circumvent the ceiling on foreign currency assets through derivatives, the BRV has been able to quietly back down from its initial action without risking the health of Venezuelan banks or changing behavior in the sector. The structured notes affair, however, provides one more example of the BRV proposing poorly thought out regulations without consulting the industry being regulated, and then quietly ignoring them or watering them down. The country's inconsistent regulatory environment will remain a risk for banks, as it does for other industries, but this time a crisis has been averted.
END COMMENT.
CAULFIELD